

Internal Revenue Service  
**memorandum**

CC:TL-N-8013-88

Br2:PLBurquest-Fultz

date: OCT 20 1988

to: District Counsel, [REDACTED] CC: [REDACTED]  
Attn: [REDACTED]

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [REDACTED]  
Pre-90 Day Case

This memorandum is a preliminary response to a request for assistance forwarded to the National Office ISP Coordinator for Data Processing. The informal request was forwarded by the ISP coordinator to Branch 2 of the Tax Litigation Division because the subject matter to be addressed, section 103, falls within that branch's subject matter responsibility.

This response is intended to provide preliminary guidance on the determination of whether a particular party to a conditional sales contract with [REDACTED] would meet the requirements of section 103(a). We will supplement this response upon receipt of additional information as to specific contracting parties and specific contractual terms between [REDACTED] and hospitals, universities, or other entities.

ISSUE

Whether the interest component of equipment rental payments received by a lessor pursuant to a lease, that for tax purposes is treated as a conditional sales contract will be treated as tax exempt interest pursuant to section 103 where the lessee is either a state university or a university medical center.

CONCLUSION

Our preliminary conclusion under the facts provided in this memorandum is that the interest component of equipment rental payments received from the University of [REDACTED] or the [REDACTED] Medical Center is properly characterized as tax exempt interest pursuant to section 103, because the health center qualifies as an instrumentality of the State of [REDACTED] under section 103(a). Our conclusion on this issue is based on the information provided with the request for technical advice and our current understanding of the creation and operation of both the University of [REDACTED] and the [REDACTED] Health Center under

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law. We caution that this response is based on our current understanding of the facts provided. Additional information is necessary concerning the status of the University and Health Center and on the terms of various conditional sales contracts between [REDACTED] and municipal, governmental, or quasigovernmental entities. Upon receipt of this additional information we will supplement this preliminary response.

#### FACTS

[REDACTED] is engaged in the business of leasing and selling a variety of medical, scientific, data processing, communications and other equipment and systems to (among others) health care providers, including hospitals and medical centers. Since [REDACTED], [REDACTED] has entered into a number of conditional sales contracts with its customers, including municipal hospitals and universities. These conditional sales contracts are structured in the form of leases; however, their attributes are such that rental payments are treated for tax purposes as payments of interest and principal. [REDACTED] has treated the interest component of the payments as tax exempt interest pursuant to section 103(a) and has reduced interest deductions by the amounts paid to finance these conditional sales contracts pursuant to section 265. Examination is considering proposing net adjustments of approximately \$[REDACTED] for tax years [REDACTED] through [REDACTED] by characterizing the interest as taxable and permitting deduction of financing costs. The statute of limitations on these years is open for examination by way of NOL and ITC carrybacks.

#### LAW AND DISCUSSION

I.R.C. § 103(a)<sup>1</sup> provides an exclusion from gross income for interest on any State or local bond. The term "State or local bond" is defined by that section as an obligation of a state, a territory, a possession of the United States, or political subdivision thereof.<sup>2</sup> Interest on industrial development bonds (pre-August 15, 1986) and private activity bonds which are not qualified bonds (post-August 15, 1986) are not entitled to exclusion under section 103(a). For purposes of this memorandum, we have assumed that the obligation created by the conditional

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<sup>1</sup> All references to sections of the Internal Revenue Code refer to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

<sup>2</sup> Under the Internal Revenue Code of 1986, a similar definition is contained in section 103(c).

sales contracts in issue are not industrial development bonds or private activity bonds.<sup>3</sup>

Treas. Reg. § 1.103-1(b) provides that "[o]bligations issued by or on behalf of any State or local government unit by constituted authorities empowered to issue such obligations are the obligations of such a unit." The regulation further provides that the term political subdivision means "any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit."

Lease-purchase contracts may be considered conditional sales contracts for federal income tax purposes if certain conditions are met. Those conditions are set forth in Rev. Rul. 55-540, 1955-2 C.B. 39. We have assumed that circumstances are present which would result in the treatment of the lease-purchase contracts as conditional sales contracts for tax purposes under the ruling, and accordingly, we do not address that issue in this memorandum.

The term "obligation" contained in section 103(a) has been treated by the Service in private letter rulings to apply to conditional sales contracts meeting certain requirements. PLR 8042143; PLR 8639005; PLR 8115076. Although private letter rulings cannot be relied on or used as precedent by taxpayers other than those to whom issued, the rulings do provide an indication of Service position on the broad definition to be given to the term "obligation." However, payments made pursuant to a conditional sales contract which does not specifically provide for the payment of interest will not be treated as having tax exempt interest component under section 103(a). Rev. Rul. 72-399, 1972-2 C.B. 73. For purposes of this memorandum, we have assumed that the conditional sales contract provides for the payment of interest as required by Rev. Rul. 72-399.

As stated in Treas. Reg. § 1.103-1(b), to qualify for tax exemption, obligations must be issued "by or on behalf of a state or local governmental unit." The issue in this case is whether the University of [REDACTED] or the [REDACTED] Hospital ([REDACTED]) qualify as governmental entities, political subdivisions of the State of [REDACTED], or as "on behalf of" issuers under the regulation.

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<sup>3</sup> We note that the years in issue end before the applicability of the private activity bond rules provided in section 103(b) of the Internal Revenue Code of 1986. We include this reference for general information purposes only.

Political Subdivision:

Treas. Reg. § 1.103-1(b) provides that the term political subdivision, as used in that section, "denotes any division of any State or local governmental unit which has been delegated the right to exercise part of the sovereign power of the unit." In determining the existence of delegated sovereign powers, the Service will follow the sovereign powers test set forth in Estate of Shamberg v. Commissioner, 3 T.C. 131 (1944), aff'd, 144 F.2d 988 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1944). See Rev. Rul. 77-164, 1977-1 C.B. 20, and Rev. Rul. 77-165, 1977-1 C.B. 21. In that case, the courts determined that generally acknowledged sovereign powers include the police power, the power of taxation, the power of eminent domain.

In applying Estate of Shamberg, the Service has stated that it is not necessary that all three of these powers be delegated; however, possession of only an insubstantial amount of any or all of the powers is not sufficient to qualify as a political subdivision. Rev. Rul. 77-164. For example, a state university having no power of eminent domain, no power of taxation, and police power limited to regulating traffic within its confines and a limited arrest power did not possess a substantial right to exercise the sovereign powers of the state, and accordingly did not qualify as a political subdivision. Rev. Rul. 77-165.

The political subdivision definition contained in Treas. Reg. § 1.103-1(b) refers to a municipal corporation, indicating that a political subdivision must have some existence separate and apart from other sovereigns. We believe that the University of [REDACTED] and the [REDACTED] Medical Center have no separate existence apart from the State of [REDACTED]. This conclusion is based on the University's status as a "[REDACTED]" of the state system of public higher education, as provided by [REDACTED]. This conclusion is more fully discussed under the heading "Instrumentalities of the State," below. Accordingly, we have concluded that neither the University nor the [REDACTED] Health Center are political subdivisions within the meaning of section 103(a), based on the current factual data we have reviewed.

On Behalf of Issuer:

There are two types of "on behalf of" issuers which may qualify under Treas. Reg. § 1.103-1(b): (1) public authorities, created under state law, and (2) corporations organized under the state's nonprofit corporation law that meet the requirements set forth in Rev. Rul. 63-20, 1963-1 C.B. 24, discussed below. The "public authority" issuer is an entity created by statute, maintaining the delegated authority to incur indebtedness on behalf of the state. In Rev. Rul. 60-248, 1960-2 C.B. 35, the

New York State Housing Finance Agency was determined to be a duly constituted public authority empowered to issue debt obligations, and therefore was determined to be an "on behalf of" issuer under Treas. Reg. § 1.103-1(b). Similarly, in Rev. Rul. 57-187, 1957-1 C.B. 65, an Industrial Development Board formed by the Code of Alabama was treated as an "on behalf of" issuer for a municipality within that state.

Nonprofit corporations, not created by statute, may also be considered "on behalf of" issuers if certain requirements are met. In Rev. Rul. 63-20, the Service announced that the obligations of a nonprofit corporation organized under the general nonprofit corporation law of a state are issued on behalf of a state or political subdivision provided the following requirements are met:

- 1) The corporation must engage in activities that are essentially public in nature;
- 2) The corporation must not be organized for profit except to the extent of retiring indebtedness;
- 3) The corporate income must not inure to the benefit of any private person;
- 4) The state or political subdivision must have a beneficial interest in the corporation while the indebtedness is outstanding and must obtain full legal title to the property with respect to which the indebtedness was incurred upon the retirement of the indebtedness; and
- 5) The corporation and the specific debt obligations in question must have been approved by the state or political subdivision.

The University of [REDACTED] and the [REDACTED] Medical Center are unincorporated, public institutions, and therefore, cannot be considered as "on behalf of" issuers under Rev. Rul. 63-20. Furthermore, the entities do not have a separate existence apart from the State of [REDACTED] nor do they have delegated authority to incur indebtedness on behalf of the state, and thus, cannot be considered as public authorities that issue debt "on behalf of" a governmental entity.

The [REDACTED] Authority (Authority), was created by statute to provide and finance the facilities, structures, and equipment needed by the institutions of higher education and health care in the state. The Authority appears to be a public authority that qualifies as an "on behalf of" issuer. It is a statutorily created "body politic and corporate," pursuant to [REDACTED], with certain enumerated powers, including the power to issue obligations

(including bonds) for any of its corporate purposes pursuant to [REDACTED]. Thus, the Authority is similar to those public authorities in Rev. Rul. 60-248 and Rev. Rul. 57-187.

At this time, we do not know whether the conditional sales contracts were executed by the Authority or by the University or Medical Center. If executed by the Authority, we believe the interest would properly be characterized as tax exempt under section 103, by virtue of the Authority's status as a political subdivision. We will supplement our response on this issue upon receipt of additional information on this issue.

Instrumentality of the State:

Treas. Reg. § 1.103-1(a) provides that interest on the obligations of a state is exempt from tax. Nonprofit Corporation Guidelines to Qualification as a Municipal Instrumentality, [REDACTED] GCM 33260, I-1127 & 2198 (June 10, 1966), concludes that one of three categories of tax exempt obligations consists of "cases where the obligations are issued directly by a state or political subdivision." The Service has concluded by private letter ruling that a state university that did not have substantial sovereign powers to qualify as a "political subdivision" could nonetheless issue obligations (via a conditional sales contract) on which the interest would be exempt from tax under section 103(a). PLR 8639005. The private letter ruling concludes that a university that was: (1) established by the state legislature as a part of the state's university system; (2) managed, operated, and controlled by a board of regents, appointed by the governor, under whose direction and authority, all legislative appropriations to the university were disbursed; and (3) was regarded by federal district courts sitting in the state to be an "arm of the state" was a part of the state. Accordingly, any "obligations" issued by the University (or the Medical Center) were obligations of the state.

As we understand the facts surrounding the [REDACTED] Medical Center ([REDACTED] Medical Center), the center was created as an identifiable part of the University of [REDACTED]; however it has no separate existence as a legal entity. Our conclusion in this regard is based on [REDACTED], which provides that the board of trustees of the University is authorized to establish and administer a hospital fund for the operation of hospital facilities, clinics and programs. Revenues received from the operation of the facilities, clinics and programs are deposited in the state treasury to the credit of the fund. Like the Medical Center, we believe the University is not a separate legal entity but exists as state owned and operated institution. Control over the University and Medical Center is centralized in the board of trustees, consisting of [REDACTED] persons; [REDACTED] of

whom are appointed by the governor; [redacted] who are elected by the student body of which they are members; [redacted] of whom are elected by the University alumni; and [redacted] ex officio members. [redacted] The [redacted] ex officio members include the [redacted], the [redacted] of [redacted], and the commissioner of [redacted]. [redacted]. The Supreme Court of [redacted] has recognized that the University of [redacted] is covered by the state's sovereign immunity. [redacted]. In [redacted] the court held that suits against the University of [redacted] were, "[redacted]". We believe this case is significant in recognizing that the University of [redacted] is something akin to being an "arm of the state," and not a separate entity from the state.

Based on the above facts, our preliminary conclusion is that the University of [redacted] may be considered "the State of [redacted]" for purposes of section 103(a), and accordingly, that interest paid by the State (via the University or Board of Trustees) pursuant to conditional sales contracts may be considered tax exempt. However, as discussed above, we will supplement this preliminary response after reviewing the specific contracts entered into by [redacted]. After a complete understanding of all facts, our conclusion on this issue may be modified, and accordingly, should not be relied on in litigation until we are able to obtain all additional information.

#### CONCLUSION

After reviewing the facts provided in the request for technical advice, the applicable [redacted] statutes, and the applicable administrative authority in this area, we have preliminarily concluded that interest paid under the conditional sales contracts between [redacted] and the University of [redacted] (or the [redacted] Medical Center) will be treated as tax exempt under section 103(a). Our conclusion in this regard is based on our preliminary conclusion that the University of [redacted] and the [redacted] Medical Center, are public institutions that are not separate from the State of [redacted].

We are awaiting a sample of contracts, and additional facts to be provided in the form of a letter from the [REDACTED] Medical Center on its status vis-a-vis the University and the State of [REDACTED]. We will supplement this preliminary response after reviewing this additional information.

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